DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0148
Sales and Use Tax
For Tax Years 2003-05

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ISSUES

I. **Sales and Use Tax**—Manufacturing Exemption.

Authority: IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; IC § 6-8.1-5-4; 45 IAC 2.2-5-8; *Indiana Dep't of Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

Taxpayer protests the assessment of use tax on one-hundred (100) percent of its purchases of certain transportation equipment, repairs, and other expenses.

II. **Tax Administration**—Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten (10) percent negligence penalty.

STATEMENT OF FACTS

Taxpayer manufactures "detinned" recycled-steel in Indiana. "Detinning" is a process described by Taxpayer as effectively diluting the percentage of tin in a steel blend to a level specified by the customer. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the tax years 2003, 2004, and 2005. The Department found that Taxpayer had made a variety of purchases on which the Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer protested this imposition of the tax and penalties on its purchases relating to certain transportation equipment that the Department determined was used exclusively for pre-production and post-production activities. An administrative hearing was held, and this Letter of Findings results.

I. **Sales and Use Tax**—Manufacturing Exemption.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(b), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department found that Taxpayer had made a variety of purchases for which Indiana sales tax was not paid at the time of purchase nor was use tax remitted to the Department. The Department assessed use tax on these purchases including Taxpayer's purchase of certain transportation equipment. The Department determined that the transportation equipment was purchased for use in pre-production and post-production activities and was subject to use tax. Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a).

Taxpayer maintains that as a manufacturer of "detinned" scrap-steel bales its purchases of certain transportation equipment and repairs on the transportation equipment are used for production activities and are subject to a fifty (50) percent sales and use exemption under the "manufacturing exemption" found in IC § 6-2.5-5-3(b).

IC § 6-2.5-5-3(b) provides an exemption from sales and use tax for "manufacturing machinery, tools, and equipment . . . if the person acquiring the property acquires it for direct use in the direct production [or] manufacture . . . of other tangible personal property."

Property acquired for "direct use in the direct production" is defined in 45 IAC 2.2-5-8(c) as "manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c).

45 IAC 2.2-5-8(d) excludes pre-production and post production activities by providing that "'direct use in the production process' begins at the point of first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its complete form."

In addition, 45 IAC 2.2-5-8(f) addresses the taxability of "transportation equipment" as provided, in relevant part, as follows:

> (1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.
> (2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.
> (3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.
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> . . .

Further, the court in *Cave Stone* held that transportation equipment used in the taxpayer's aggregate stone production process was exempt from sales tax because the equipment was essential to achieving the transformation of crude stone into aggregate stone. *Indiana Dep't of State Revenue v. Cave Stone, Inc*., 457 N.E.2d 520, 525 (Ind. 1983). In arriving at that decision, the *Cave Stone* court found that the "focus of analysis should be whether the equipment is an 'integral part of manufacturing and operates directly on the product during production.'" *Id*.

Accordingly, transportation equipment purchased for direct use in the production of a manufactured good is subject to use tax unless the property used has an immediate effect on the good produced and is essential to the integrated process used to produce the marketable good. When equipment is used during production, during pre-production, and during post-production, the equipment will be exempt only to the extent that it is used for production purposes.

In applying any tax exemption, including the exemption found within 45 IAC 2.2-5-8(c), the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

A. Equipment: "Kawasaki Loader" and "Liebherr Scrap Handlers."

During the course of the protest, Taxpayer submitted information for the purchase of a "Kawasaki Loader" and two "Liebherr Scrap Handlers." Taxpayer also submitted pictures illustrating how these pieces of equipment are used to load materials off of rail cars or trucks, to pile the materials by type of metal content, to move materials from piles to the mixing area, to mix the materials in the mixing area, to load the materials from the mixing area into the baler, to move baled steel from the baler to piles, and to load the bales onto rail cars or trucks for transport to customers. Taxpayer maintains that since these items of machinery are used to mix and load ingredients of the final product into the baler, the items of machinery are partially used directly in the manufacturing process entitling the purchases to a fifty (50) percent manufacturing exemption.

Taxpayer has provided sufficient information to demonstrate that the items of transportation equipment are used in an exempt manner part of the time. Taxpayer has asserted that the equipment is used in an exempt manner fifty (50) percent of the time and should be fifty (50) percent exempt. However, Taxpayer has not provided any support of how it arrived at the fifty (50) percent exemption. In addition, Taxpayer did not cite any statute, regulation, or case law for the proposition that the Department was required to accept Taxpayer's assertions as to the nature of these transactions without providing the supporting documentation.

Taxpayer's uses of the transportation equipment can be broken down into taxable and exempt categories, as follows:

Loading materials off of rail cars and trucks; pre-production, taxable
Piling the materials according to type of metal content; pre-production, taxable
Moving the materials from piles to the mixing area; pre-production, taxable
Mixing the materials in the mixing area; production, exempt

> Loading the materials from the mixing area into the baler; production, exempt
> Moving the baled steel from the baler to piles; post-production, taxable
> Loading the bales for transport to customers; post-production, taxable

Since only two of the above uses of the equipment are tax exempt, Taxpayer's suggested exemption rate of fifty (50) percent is not reasonable. Therefore, since Taxpayer has provided sufficient information to support that the transportation equipment is used in an exempt manner for two out of its seven uses, entitling Taxpayer to a thirty (30) percent exemption rate for the equipment is more reasonable.

Therefore, Taxpayer's protest is sustained as it relates to the cranes and handlers being partially exempt, but is denied as it relates to the exemption percentage.

B. Repairs, Maintenance, and Other Expenses.

Taxpayer protests the tax imposed on the repairs, parts, oils, and fuels purchased for the operation of the scrap handlers and the crane (discussed above). During the course of the protest, Taxpayer submitted information asserting that a "machine link," "grappler parts," and a "grappler" were purchased to repair the "Liebherr Scrap Handlers." The audit report on pages 5-6 also lists these parts as purchased for the "Liebherr Scrap Handlers."

Pursuant to 45 IAC 2.2-5-8(h)(2) "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, the "machine link," "grappler parts," and a "grappler" purchased to repair the handlers would be tax exempt to the extent that the handlers are exempt. Thus, the "machine link," "grappler parts," and a "grappler" would be thirty (30) percent exempt (as discussed in part A above).

However, Taxpayer failed to submitted information citing specifically the amounts protested or to give any details about oils, fuels, and other parts that it asserts were purchases for use in or to repair the handlers or cranes. Moreover, Taxpayer did not cite any statute, regulation, or case law for the proposition that the Department was required to accept Taxpayer's assertions as to the nature of these transactions without providing the supporting documentation.

In fact, IC § 6-8.1-5-4(a) provides:

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

Pursuant to IC § 6-8.1-5-1(b), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect. Since Taxpayer has failed to produce any documentation that demonstrates that the Department's assessment based was incorrect as it pertains to oils, fuels, and other parts, Taxpayer has failed to meet its burden.

Therefore, Taxpayer's protest of the repairs, maintenance, and other expense amounts is sustained as it relates to the partial exemption of "machine link," "grappler parts," and a "grappler," but is denied for all the other expenses.

FINDING

Taxpayer's protest is granted in part and denied in part.

II. **Tax Administration**—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and ten (10) percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person . . . incurs, upon examination by the department, a deficiency that is due to negligence . . . the person is subject to a penalty."

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer has established that it does not owe some of the proposed assessments, Taxpayer has not affirmatively established that its failure to pay the remaining deficiencies was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest to the imposition of the penalty is respectfully denied.

AB/WL/DK-September 18, 2007